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February 15, 2006

AGENDA ITEM 3

TO: MEMBERS OF THE BENEFITS AND PROGRAM ADMINISTRATION COMMITTEE

I. SUBJECT: Assembly Constitutional Amendment 23 (Richman) - As Amended on January 30, 2006

California Public Employee Retirement Plan

II. PROGRAM: Legislation

III. RECOMMENDATION: Oppose

ACA 23 would create a fundamental shift in the retirement security of future public employees hired on or after July 1, 2007.

IV. ANALYSIS:

ACA 23 would amend the California Constitution to establish the California Public Employee Retirement Plan. It would define what constitutes a defined benefit plan and a voluntary defined contribution plan. Further, it would establish the normal retirement age, employee and employer contribution rates, the definitions of "salary" and "public safety employees," and other components of the proposed plans. The measure provides that public employees hired on or after July 1, 2007 would be required to enroll in the newly proposed defined benefit (DB) plan with its reduced retirement benefit factors, and would permit voluntary enrollment in a defined contribution plan.

ACA 23 must be approved by a two-thirds vote of the Legislature, and then by California voters in a statewide election.

ACA 23 specifies that the proposed constitutional amendment shall apply to all public agencies. However, this analysis will only consider the impact of ACA 23 on CalPERS.

Background

Defined Benefit Plans

DB plans provide participants a predictable lifetime benefit based upon a participant's years of service under the plan, retirement formula factor, and age. The majority of public sector DB plans are funded through employee and employer contributions which, by plan design, may fluctuate on an annual basis. Public sector DB plans usually provide retirees some type of annual cost-of-living increase to offset loss of purchasing power due to inflation. Investments are managed by professional investment staff. If investment returns fall below the assumed rate of return, employers are liable for the additional assets necessary to fund the defined benefit. Likewise, if investment returns are above the assumed rate of return, the excess assets reduce employer costs.

Defined Contribution Plans

DC plans include 401(k), 403(b), and governmental 457 plans. A participant's benefit from a DC plan is based upon the contributions by the participant, any employer contributions, and investment gains or losses. The employer or the participant may be responsible for the plan's administrative expenses, but investment management fees are typically paid by the participant.

Benefits can be paid from a DC plan in several ways. The most common methods are monthly payments until account assets are depleted, a lump-sum payment of account assets, or the purchase of a private annuity that pays a monthly benefit for a fixed period. DC plans allow participants to defer taxes on the contributions made to the plan (up to a maximum amount), thereby lowering their annual taxable income. In addition to participant contributions, most DC plans permit employer contributions, which participants "own" after a specified vesting period.

CalPERS Defined Benefit Plan

CalPERS provides a DB plan for employees of the State of California, schools, and contracting local agencies. CalPERS is the largest public pension fund in the United States, with a market value of $200 billion as of November 2005. The CalPERS Board applies strict guidelines for investing these assets, including standards for safety, diversification, and liquidity.

The CalPERS DB plan provides a lifetime benefit based upon a member's years of service, age, retirement benefit formula, and final compensation. Participation in the DB plan is mandatory for most state employees, classified school employees, and employees of a contracting local agency. Benefits are funded by member contributions, employer contributions, and investment returns generated by CalPERS.

Employers can select from a variety of formulas and contract options for all employees or groups of employees. Most local agency employers adopting a new benefit package or an enhancement to an existing package do so after completing contract negotiations with an employee group. Local agency employers are required to have CalPERS retirement benefit changes adopted by a majority vote of the governing body after the proposal has been publicly heard before the body on at least two occasions, no less than twenty days apart.

CalPERS maintains separate accounts for members and employers. Member contributions are fixed by statute and forwarded to CalPERS for deposit into individual accounts. Upon separation from employment, a member may choose to withdraw his/her member contributions plus interest or to leave the funds in the system. If the funds are withdrawn, no employer contributions are paid to the member. All retirement plans provided by CalPERS include a basic death and disability benefit for members.

In addition to the CalPERS DB plan, the state offers supplemental savings plans, including 401(k) and governmental 457 plans for its employees on a voluntary basis. CalPERS also administers a 457 plan available to contracting local agencies.

Annual Valuations: Employer Contribution Rates

Employer contribution rates are determined by CalPERS during an annual valuation of the assets and liabilities of each employer's retirement plan(s). When establishing employer contribution rates, the actuarial calculations are based upon a variety of actuarial methods and assumptions. The methods include smoothing of assets held in trust by CalPERS. The employer's contribution consists of the following two main components:

1. The employer's normal cost for benefits. This is the constant cost an employer would need to pay for one year of service if all actuarial assumptions are met.
2. The amortization of the unfunded liabilities or surpluses for its population that result from changes in benefit levels, population characteristics, and actuarial gains or losses.

Employer contribution rates can fluctuate on an annual basis due to a variety of factors. The Board has taken steps to minimize the fluctuation in employer rates by implementing risk pooling for public agencies at CalPERS. Risk pools reduce or eliminate the large fluctuations in the employer contribution rate caused by unexpected demographic events. The Board has also recently adopted a new rate stabilization method, also referred to as "smoothing," that reduces the volatility associated with asset gains and losses.

The rates always reflect the value of assets from approximately one year prior for the state and two years prior for public agencies. For example, the current contribution rate required of public agency employers for fiscal year 2005/2006 is based upon the value of assets and employee demographics as of June 30, 2003.

Over the past 10 years (ending June 30, 2004), member contributions accounted for 11.5% and employer contributions represented 11.7% of the income to the plan, with investment income providing approximately 76.8% of income to the plan. During this time period member contributions equaled employer contributions because members always make contributions, regardless of funded status. Employer contributions vary depending on investment earnings, with employers receiving the benefit of positive investment earnings.

Proposed Changes

- ACA 23 would require employees hired on or after July 1, 2007 to enroll in the "California Public Employee Retirement Plan." The plan consists of a required DB plan and a voluntary DC plan.

- The DB component of the plan would:

  - Provide the following benefit formulas:

    - 1 percent of highest average salary for each year of service for employees covered under Social Security, except public safety employees.

    - 1 ¾ percent of highest average salary for each year of service for employees not covered under Social Security, except for public safety employees.

    - 2 percent of highest average salary for each year of service for public safety employees.

  - Establish the normal retirement age of 55 for safety and 65 [or Social Security Age] for miscellaneous members. An employee may retire before normal retirement age at an actuarially reduced rate.

  - Require the actuarial normal cost to be paid in equal amounts by the employer and employee.

  - Establish that the DB portion of benefits would be based on highest average salary over three consecutive years.

  - Require public agencies that currently provide disability or death benefit for its employees to continue to do so, including persons employed on or after July 1, 2007.

- Require that surplus assets be retained in the plan solely for the payment of the defined benefit, disability and death benefits and administrative costs of the plan.

- Provide that an employee's right to vested benefits under this plan must be established by law.

- Provide that an employee hired on or after July 1, 2007 shall not be eligible for employer-paid retiree health benefits until he or she attains normal retirement age (i.e. 55 for safety and 65 [or Social Security Age] for miscellaneous) and retires, unless the employee retires on disability. An employee who retires prior to his or her normal retirement age may receive health care benefits available through his or her public agency by paying the entire cost of these health care benefits.

- <u>The DC component of the plan would:</u>

  Define the DC plan as providing for a pension benefit equal to the combined employer and employee contributions plus interest and net investment earnings, less administrative expenses and other costs. In summary, the DC plan would:

  - Require the plan to be administered by CalPERS, CalSTRS, 1937 Act systems, a charter city, or the UC Retirement System.

  - Cap employer contribution rates at one dollar ($1) of matching funds for each dollar contributed by an employee, not to exceed 4 percent of the employee's salary.

  - Establish methods for exceeding the prescribed employer contribution in certain instances (e.g., voter approval for state employees on a proposition of a statewide election, voter approval of a proposition by local agencies and districts within their respective jurisdiction).

  - Provide that an employee's vested right to receive employer contributions made to the plan on his or her behalf must be established by law.

<u>Legislative History</u>

2005 ACA 5 (Richman) - Would establish the California Public Employee Defined Contribution Plan for public employees hired on or after July 1, 2007 and would prohibit employees of governmental entities within California from enrolling in a DB plan that provides a benefit based on age, service credit, and final compensation. *CalPERS' Position: Oppose.*

ACA 1x (Richman) - ACA 1x is nearly identical to ACA 5. ACA 1x, however, does not propose to limit employer contributions to the DC plan.
CalPERS' Position: Oppose.

ACAX1 8 (Richman) - Would establish the California Public Employee Defined Contribution and Hybrid Plans for public employees hired on or after July 1, 2007 as administered by CalPERS, CalSTRS, UCRS, or a private administrator contracted by a local entity. Requires that plans offer death and disability benefits, and establishes employee and employer contribution rates. *CalPERS' position: None.*

AB 3x (Richman) - Companion bill to ACA 8x containing statutory language to implement ACA 8x, if passed by the Legislature and approved by the voters. *CalPERS' position: None.*

SB 888 (Ashburn) - Would require the establishment of a hybrid retirement program for public employees hired on or after January 1, 2006, which consists of a defined benefit plan and a defined contribution plan. *CalPERS' Position: None.*

2004 Chapter 214 (SB 1105, Comm. on Budget & Fiscal Review) - Established the Alternative Retirement Plan for new state employees whereby employees contribute to a DC plan administered by the Department of Personnel Administration/Savings Plus Program for their first 24 months of service. After the first 24 months, the employee becomes a member of the CalPERS DB plan. *CalPERS' position: None.*

1996 AB 3252 (Kaloogian) - Would have created the Public Employees' Defined Contribution Retirement Plan. Active state employees and contracting public agency employees would have had the opportunity to transfer their CalPERS DB assets to a DC plan, and participate only in that DC plan. *CalPERS' position: Oppose.*

1990 Chapter 1659 (SB 2026, Craven) - Established the CalPERS 457 Deferred Compensation as a supplemental savings plan for employees of contracting public agencies. Public agencies may contract with CalPERS to provide this voluntary program to their employees. All program costs are paid by those agencies and participants. *CalPERS' position: Sponsor.*

Issues

1. Arguments by Those in Support

ACA 23 was introduced by Assembly Member Richman on September 8, 2005, the last day before the Legislature left for recess and amended on January 30, 2006. Proponents argue that the cost of existing DB benefits is too high, and California has among the nation's most generous public pension plans.
Organizations in Support: None

2. Arguments by Those in Opposition

Opponents of ACA 23 state that outlawing DB retirement plans for all public employees in place of risky DC plans is dangerous. Opponents state that ACA 23 would create an un-level playing field by mandating a two-tiered retirement benefit structure that affords employees hired before July 1, 2007 a retirement plan different from those hired on or after this date. Opponents argue that this will result in employees working alongside one another performing the same job functions, but receiving vastly different retirement benefits, thereby creating morale issues and making it more difficult for state and local governments to recruit and retain quality personnel.

Further, opponents state that current defined benefit retirement programs have a proven track record of providing efficient and cost-effective death and disability benefits for public safety personnel that cannot be comprehensively matched by private insurance products.

Organizations in Opposition: California Teachers' Retirement Board; California Federation of Teachers; California Retired Teachers Association; California School Employees Association; California Teachers Association; California Professional Firefighters; California State Employees' Association; Faculty Association of California Community Colleges; United Teachers of Los Angeles

3. Legislative Policy Standards

The Board's Legislative Policy Standards suggest an oppose position on proposals which: (1) threaten the trust; (2) create a benefit change for a subcategory within a member classification, unless the proposal promotes the concept of Board-approved pooling; or, (3) reduce or limit the Board's administrative authority.

ACA 23 creates a fundamental shift in the retirement security of future public employees by effectively closing existing defined benefit plans to new public employees hired on or after July 1, 2007. This bill would also potentially conflict with the Board's plenary authority to administer the system related to performance of its actuarial services. Finally, this bill threatens the trust because potential closure of the existing DB plan could have an adverse impact on the existing Public Employees' Retirement Fund. CalPERS staff, therefore, recommends that the Board oppose this measure.

4. Impact of Proposed DB Plan

Aspects of the proposed DB plan are unclear, but it appears restrictions placed on the assets would preclude combining the proposed DB plan in ACA 23 with the existing DB plan. This would effectively close the existing DB plan and could have a negative impact on the rates of return, amortization methods and employer costs.

A. Impact on CalPERS Actual and Assumed Rate of Returns

Because ACA 23 would allow current members to continue participation in the CalPERS DB plan, the current system would remain in operation throughout the lifetime of current members and their survivors. By closing the current DB plan to new members, the bill would result in reduced future contributions that CalPERS would otherwise receive. Over the long term, this is likely to affect the asset allocation of the fund; as members begin to receive retirement benefits in the future, the asset allocation will need to become more liquid. This liquidity is likely to have an adverse impact on fund performance in future years, offsetting some of the savings to employers. This would reduce the assumed rate of return on current DB programs resulting in an increase in the cost of existing liabilities. In addition, ACA 23 would result in a consistently aging population in the DB plan, creating an adverse affect on the actuarial balance of the funds administered by CalPERS.

B. Impact on Actuarial Methods and Assumptions

If the plan is closed to new members, the CalPERS Board will need to assess whether to change the method of amortizing the unfunded liability, as well as the period of time over which the unfunded liability is amortized. In particular, the Governmental Accounting Standards Board (GASB) in Statement 27, *Accounting for Pensions by State and Local Governmental Employers*, requires that when a plan is closed to new entrants, the method of amortizing the unfunded liability must be either:

1) A level dollar amount (i.e. the same dollar payment over each year of the amortization period), or

2) A level percentage of declining payroll of active members still covered by the plan. This means that payments start considerably higher than the payments under current Board policy (as applied to an open plan) and each year decrease by the same percentage as expected declining covered payroll.

It is likely that the Board, in order to produce employer contribution rates that comply with Generally Accepted Accounting Principals, would need to revise its policy on the method used to amortize the unfunded liability to one of the two described above and shorten the current amortization period. Changing the amortization method and period to be in compliance with a closed plan would result in a higher contribution rate and employer cost in the near term.

C. Many public employers would be required to maintain multiple retirement plans

Because ACA 23 only impacts employees hired on or after July 1, 2007, existing public employees would remain enrolled in their existing DB retirement plans. In the case of CalPERS' contracting agencies, the agencies would be required to fund what would essentially be three retirement plans: the existing DB plan; a proposed DB plan; and a DC plan. This will increase administrative costs for the agencies.

With respect to state employees, existing state employees would remain in CalPERS. The state would also maintain a DB and DC plan for all new state employees. The Alternative Retirement Program enacted during 2004 would also be administered by the Department of Personnel Administration through July 1, 2009. Presuming that the DB plan (as the default plan under this proposal) provided under ACA 23 would supercede the Alternative Retirement Program, the Alternative Retirement Program would apply to those employees hired before July 1, 2007, and must remain in effect through the first two years of employment. The state, therefore, would be maintaining four retirement programs for a period of time.

5. Impact on New Members

Proponents argue that ACA 23 provides greater budget predictability, and helps restore fiscal responsibility to state and local budgets. Consequently, it may have the opposite affect on new public employees. There are provisions in ACA 23 that could affect the member's ability to budget and plan for retirement, such as:

- ACA 23 would permit instituting different vested rights for new members participating in the proposed plans than those provided by existing law for current members who are included in the existing DB plan. Existing case law prohibits changes in a pension plan which result in disadvantages to employees which are not accompanied by comparable new advantages. This bill could make that existing law inapplicable to new members in the new plans. As a result, ACA 23 could potentially be used to deprive new members of what are currently considered to be vested benefits

- The normal retirement age would be 55 for safety employees and 65 [or Social Security Age] for miscellaneous employees. Under the provisions of ACA 23, the normal retirement age for miscellaneous employees could fluctuate since the age requirement is tied to the Social Security age of retirement which can be changed by federal legislative action.

- Although retirement ages are rising and new public employees may intend to work until age 65; nearly 40 percent of retirees leave the workforce earlier than planned for unforeseen life situations. Retirees who do not work until normal retirement age will enter retirement with lower benefits and higher out-of-pocket expenses for health coverage. For example, under ACA 23 a member may retire before normal retirement age at an actuarially reduced benefit amount and continue to receive health benefits by paying the entire cost. Having retirement benefits actuarially reduced means that the applicable benefit factors at ages earlier than the normal retirement age must be reduced by taking into account life expectancies and expected investment return to ensure cost neutrality for the employers. These actuarial adjustments will result in a reduction in the applicable benefit factor of about 40 percent for those miscellaneous members retiring at age 60 (i.e. 5 years before the normal retirement age). This means that a 60 year old miscellaneous employee covered by Social Security with 25 years of service would receive approximately 15 percent of his or her salary (i.e. .6 percent per year of service) at retirement and no other assistance to help cover medical premiums.

- ACA 23 does not contain any disability benefit design information other than providing that employees who retire for disability may be eligible for employer-paid health benefits. This alone, based on the scenario above, may create an increased number of disability retirement applications.

6. Impact on GASB 27 Compliance

In its current form, ACA 23 could lead to situations where the contribution rates paid by employers do not comply with the generally accepted accounting standards as provided by Governmental Accounting Standards Board Statement No. 27 (GASB 27). In such cases, the employers would have to track and "book" the difference between a GASB compliant rate and the actual rate paid to CalPERS in order to satisfy GASB 27 requirements.

7. Start-up Costs

ACA 23 does not establish a fund for start-up costs of the proposed DB plan or DC plan. Existing DB plans charged with administering these new plans may not be permitted to use their existing administrative funds to administer the new plans.

V. STRATEGIC PLAN:

This is not a specific product of the Annual or Strategic Plans, but is part of the regular and ongoing workload of the Office of Governmental Affairs.

VI. RESULTS/COSTS:

ACA 23 would effectively close the current CalPERS DB plan to any new enrollment, but would not eliminate the plan. Current DB plan members would continue to participate in the CalPERS DB plan by accruing service credit and receiving retirement benefits. Contracting agencies and the state would be required to fund any liabilities accrued with respect to the remaining DB plan participants.

Program Costs

Due to the lack of specificity in the proposed DB plan design, it is not possible at this time to determine the precise financial impact of ACA 23. CalPERS, however, expects this bill would have a substantial financial impact, but additional information is needed to quantify the impact.

In order to understand the potential impact of ACA 23 it may be helpful to review the analysis for ACA 5 that was prepared last year. In that analysis, it was identified that closing the existing DB plan would most likely result in a change in the way existing unfunded liabilities would have to be amortized. While there are a number of ways that unfunded liability could be amortized, for the ACA 5 analysis, it was based upon the only available interpretation of CalPERS' current policy, namely that the amortization payments would have to start higher and decrease over time as the payroll of covered active employees declines. The same would apply if ACA 23 were to be enacted.

Further, the analysis for ACA 5 was done assuming no change in amortization period. Should ACA 23 be enacted, the Board would have to determine whether the method and period used to produce the estimate below are appropriate.

The following table shows the estimated financial impact of ACA 5 as it was presented last year in the bill analysis. The financial impact shown below takes into account the changes in amortization payments for the closed DB plan and the contributions the state would have had to make to the DC plan under ACA 5. Once again, ACA 23 does not contain enough information to properly assess its financial impact. The following table is provided as a guideline only. Depending on the final design of the "California Public Employee Retirement Plan," the financial impact of ACA 23 might be similar to what is included in the following table.

Estimated Impact of ACA 5 (in $ billions)
Amortization Method: Level Percent of Declining Payroll
Amortization Period: Same as Current Policy

	First Year (2007-08)	Ten Years (2007-08 to 2016-17)	Twenty Years (2007-08 to 2026-27)	Thirty Years (2007-08 to 2036-37)
State	(0.42)	(1.52)	8.14	19.00
Schools	(0.14)	(0.18)	2.88	5.64
Public Agencies	(0.26)	0.67	4.89	11.20
Total	**(0.82)**	**(1.03)**	**15.91**	**35.84**

Negative amounts represent increased costs to employers and positive amounts represent decreased cost to employers.

Again, we emphasize that what is shown above is the impact of ACA 5 that was introduced last year. The impact of ACA 23 will be different than what is shown above but we do not have enough information at this point to properly assess its financial impact.

Administrative Costs

The administrative costs for the current CalPERS DB plan are not likely to change significantly in the short-term.

If CalPERS were to administer the proposed DB and DC plans, the CalPERS Supplemental Savings Program would need to be significantly expanded.

There would also be significant member education costs that the current DB plan would incur. Education costs include written communications to members, presentations, and developing calculators to calculate benefits under the proposed DB plan and the voluntary DC plan.

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